Is the Retirement Income Covenant Immoral?

Dr Paul Moran CFP®

The Retirement Income Covenant in Australia is a regulation introduced under the Superannuation Industry Supervision Act 1993 (SIS Act) that took effect from 1 July 2022. It requires all APRA regulated super funds to formulate a retirement income strategy and publish a summary of the strategy on the superannuation entity's website. The covenant is arguably aimed at broadening industry focus beyond the accumulation phase to advance the decumulation, or retirement, phase of superannuation.

There is current discussion of extending this to self-managed super funds.

The three key objectives outlined by Treasury in its position paper regarding the covenant are to: maximise retirement income; manage risks to the sustainability and stability of retirement income; and have some flexible access to savings during retirement.

I take particular note of the third objective – to have 'some' flexible access to savings! What does this mean?

One of the dominant reasons for the covenant's existence is a perceived inefficiency of the traditional superannuation retirement income product – now known as an 'Account-Based Pension (ABP)'. An ABP is a de-cumulation product where a superannuant who meets certain conditions, including retirement post age 60 or turning 65, is able to convert their accumulated lump sum balance into a flexible pension, or income stream, and draw a regular payment to fund lifestyle needs. I will not be discussing Transition to Retirement income streams in this paper given their short-term application.

While retirees have always been able to purchase an annuity with all or some of their accumulated balance, ABPs have been the preferred option, over the past 20 or so years, due to their flexibility.

The term 'immoral' is an adjective that describes actions or behaviours that do not conform to accepted standards of morality. It is often used to refer to actions that are considered unethical, bad, wrongful, wicked, or evil. The Cambridge dictionary describes that immoral actions or behaviours are seen as morally wrong and are generally outside society's standards of acceptable, honest, and moral behaviour.

I don't use the word immoral here flippantly, but rather out of concern that choices are being made by large financial institutions to 'encourage' investors into specific financial products. We have been here before.

A lot of the data used to support the retirement income review recommendations are based on surveys, but poor financial literacy and financial knowledge must surely compromise the results of such surveys. As an example, a number of retirees were happy to use the home to fund aged care, but there is no data regarding the need for a surviving partner to continue to live in the property. The survey assumes that either both partners enter care together, or one has already died.

Fundamentally, the Retirement Income Covenant is a requirement for superannuation funds to provide alternative income stream products to better suit retirees. Of course, this seems to be code for the development of financial products that encourage retirees to spend their retirement nest egg and die with little left.

In other, more simple words, purchase a type of annuity.

The products being developed seem to be centred on annuity principles in one form or another. This is likely influenced by actuarial studies that have shown that retirees could live a more extravagant existence throughout their retirement if they just took advantage of a lifetime income stream rather than, or to supplement, the more popular ABP.

Many of these studies reflect on the advantages of supplementing a welfare-based age pension.

With all respect to Actuaries, their reports are number-based and become compelling given the seemingly definitive probabilities and mathematical proofs offered. They do, however, tend to treat people as a homogenous group, or cohorts, rather than individuals. As a Financial Planner dealing with ‘real people’ every day I can see issues with this approach.

More worrying is evidence often presented to suggest that retirees don’t know what is good for them because of a lack of financial literacy. This means that the retirement products being developed are unlikely to be selected by retirees unless there is some form of nudge. Nudging typically comes in the form of opt-out, as was typified by Richard Thaler’s system introduced in the USA to make employees auto-enrol in the opening of a retirement savings account with their employer. Known as ‘save more tomorrow’, it simply changed membership to a company’s retirement plan from opt-in to opt-out. Unfortunately, there was no compulsion to actually contribute.

Nudging has become mainstream in much of government thinking as a truism, and an example of this is the UK Government’s Behavioural Insight department being known as the ‘nudge unit’.

But ‘nudging’ isn’t always appropriate as it is a technique that has been used commercially in marketing and sales for decades. You could argue that the current epidemic of ‘vaping’ is a nudge to encourage young people to take up a nicotine addiction without cigarettes.

I wonder who might be behind such a campaign?

> *“…entitled to rule over others.” — Gerd Gigerenzer, on the paternalism implicit in nudging*

He described a particular type of paternalism – libertarian paternalism – where the choice architects decide what is best for, in this case, retirees.

Gigerenzer further suggests that nudges and defined processes, such as the minimum drawdown rates, default investment choices and default retirement options, act as quasi recommendations. The institution would not offer them as default if they weren’t the ‘best’ option for me?

Each product manufacturer or superannuation fund is expected to create a financial product or group of products that suits their clients' needs. Of course, there is no homogenous group in a fund of hundreds of thousands of members. A few have more than a million members.

Surely the process of managing a complex network of financial products needs individualised attention with enough personal information collected to allow for an informed decision. But some think this can be automated with access to personal information. In their submission to the Treasury regarding the covenant, Aware Super (as an example) discussed that personal advice subjects 'members to onerous fact finds'. Further, they believe that accessing member data from MyGov, the ATO and Centrelink should be sufficient to be able to make recommendations that will impact someone's life for 30–40 years. Again, apologies for being sceptical.

I fully understand that there are not enough Financial Planners and Advisers to service the needs of the growing group of retirees, and also that not all retirees need or want personal advice. I also understand the opportunity that large financial institutions could offer in the provision of personal advice to those members looking for it – provided their staff were appropriately trained and qualified. But that is probably a topic for another day.

We might break down retirees into several categories with very different needs. Let's start with a group we might call "Frugal by necessity". This group will primarily receive their funding from the age pension with little else to supplement any income. They may or may not own a home and are likely to retire with liquid assets of less than $250,000. I have chosen this amount as it reflects the lower assets test threshold for a single person.

Having less than $250,000 of liquid funds means that significant financial costs such as home repairs and maintenance, motor vehicle costs and even holidays are likely to need to be funded from this nest egg. Investing, say, 40% of this balance into an annuity style product is likely to offer a lifetime return of around $5,500 (indexed) per annum. If this group are already receiving the full age pension, there is no additional benefit offered by some contemporary annuity providers that may partially discount the value of the annuity for Centrelink means-test purposes.

Questions worth sitting with

Why should we have a retirement income covenant? What evidence is there to support it? Who is it targeted at? Isn't spending by boomers the cause of inflation? What is the 'sweet spot' and who qualifies for it?